Business Protection

Guide to business succession for companies

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This technical guide details the need for business succession planning for companies, suitable solutions, and the impact and tax treatment of applying them.

In this guide we look at business succession planning considering what happens to the ownership of a company should a business owner die, or be unable to return to work due to critical illness. We look at the need to make financial provision not only from the perspective of the company and its owners but also their families and dependants. We also look at the core principles and how arrangements are put in place.

This guide deals solely with the purchase/sale of shares between the individual shareholders. A separate guide is available (Guide To Company Share Purchase) which examines an alternative method of business succession planning, called 'the corporate route', where the company itself– and not the individuals – buy the shares from the estate of the deceased shareholder or the critically ill shareholder. This results in the shares bought being cancelled.

Memorandum and Articles of Association.

Every company is required to have a Memorandum and Articles of Association. The former will confirm the company name, registered office and what the purpose of the company is. The Articles of Association set out the rules for how the company will be run, and will cover issues such as the transferring and selling of shares.

Any business succession arrangements put in place by the company and its directors must be consistent with the Memorandum and Articles of Association.

If "standard" Memorandum and Articles are adopted the shareholders will not have specific options to, nor will they be compelled to, buy from or sell shares to their co-shareholders.

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1 The Need

Like many thousands of companies with a few shareholders who also hold key positions in the business, the death or inability to return to work of any of them can cause major issues for the other shareholders/co-owners, and for their respective families. The following are just some of the questions that can arise:

- What happens to the shares on death/critical illness of a co-owner?
- Who will control the company?
- What happens if a sale of the shares is necessary? Who will be able to buy them? Who can afford to buy them?
- What are the shares worth?
- Will the family secure sufficient income if they retain the shareholding, or would they prefer cash?
- What are the rights of a shareholding director if they become critically ill and are unable to return to work?

In this guide we will consider the ownership of the company after the death or critical illness of a shareholder/co-owner.

What happens to the shares on death?

When a shareholder dies, their shares will form part of their estate and will pass to their beneficiaries in accordance with their Will. If there is no Will, the shares will pass under the rules of intestacy.

Some potential problems immediately become apparent:

- What will the beneficiaries do with the shares?
- Do they really want them?
- Will they try to sell them and who will buy them?
- Can they 'force' the other shareholders to buy the shares?
- Do the surviving shareholders/co-owners want to have the beneficiaries as shareholders/co-owners of the business?
- Would shareholders want a 'non-involved' critically ill shareholder to retain a (possibly significant) share in the business?

Following a shareholder's death, in many cases it is likely that it will be the deceased's widow(er)/civil partner who is the beneficiary. Receiving, through the estate, a shareholding in the company may not be very helpful to the beneficiaries under the deceased's Will. It may be their only asset apart from the family home and their only source of potential income (if dividends are declared) and it may be very difficult to realise that value.

In this situation, more questions may arise:

- What benefit will the shares be to them?
- Will they be able to realise the value of these shares?
- Do they have any experience of running, or taking part in the management of a company?
- Can they draw a salary and/or will they be entitled to any dividends?
- Will the surviving shareholders/co-owners want them as a fellow shareholder(s) and/or director(s)?

Normally, because of these issues, it is most likely that the beneficiaries will be far better off, not with the shares, but with a lump sum to provide a regular income from another, independent source.

Is selling the shares a solution, and, if so, what would they be worth?

The shares are unlikely to be quoted on the Stock Market, and there is therefore unlikely to be a ready market for them especially if the shareholding is a minority one. If a buyer can be found, the sale of shares will require a valuation at the point they are to be sold. If a key shareholder has just died, this could result in a considerable drop in the value of the company, and therefore in the value of the shareholding. The same may be true following a key shareholder's critical illness.

You also need to consider that there may be provision in the company's articles of association for 'pre-emption rights'. These rights can state that no shareholding can be sold without first being offered to the current shareholders for a price to be determined in accordance with the articles. This doesn't necessarily mean that a sale to a third party is not possible but even if such a sale is possible, buyers may be few and far between.

In most cases, the most likely buyers will be the continuing shareholders. But if there is insufficient cash and no ready or economically acceptable access to funds through borrowing, this route may not be possible. And if the shareholding of the deceased or critically ill shareholder is a small minority holding, then the other shareholders may see no need or benefit in buying the shares – they will control the company (and the dividend policy) without the need to purchase any more shares.

Who will control the company?

Those with 51% or more of the shares in the company will control the company.

However, despite the likely lack of any compulsion to buy the shares of a deceased or critically ill shareholder, the continuing shareholders would need to consider how they might feel about having 'non-involved' shareholders.

What happens if the critically ill shareholder or their family need to sell the shares? Who will buy them? Who will be able to afford to buy them?

It is unlikely that the surviving shareholders/co-owners will have sufficient funds to buy the shares, or that sufficient cash will be sitting in the company for the company to buy the shares and cancel them. Borrowing may be possible but the availability and cost of capital can depend on circumstances that are outside of the shareholders' control. This could lead to a lack of confidence within the company, and lack of total commitment on the part of the directors, which could lead to the business stagnating. In addition, employee confidence in the directors of the business could fall, leading to retention issues (and also time-consuming recruitment activity) on top of all the other normal business considerations.

So, in summary…

What the continuing shareholders are likely to need is to be able to buy the shares from the deceased's estate or, with his or her agreement, from the critically ill shareholder. Naturally, to achieve this they need money at the right time and undiminished by tax.

2 The Solution

Introduction

To start with:

- the shareholders need to agree, while they are all in good health, how the shares will be dealt with on death, and/or critical illness, so that there is a ready and willing buyer of the shares – and then document that agreement,
- they also need to plan in advance so that the necessary funds are available when a shareholder dies, and/or suffers a critical illness, and do so in a tax efficient manner, both from the perspective of the company and the individuals concerned.

STEP 1: The Agreement:

Double option to cover purchase following a shareholder's death
Most agreements involve options to buy and sell, rather than a firm sale and purchase agreement. This type of share purchase agreement is called a 'double option' or 'cross option' agreement. The agreement could be included in the company's articles of association, or as is more likely to be the case, in a separate agreement entered into by the shareholders.

The agreement would, broadly speaking, be in two parts. Firstly, on death, it gives the holder of the shares (i.e. the deceased's executors) the option to sell the shares, and, secondly, it gives the other shareholders a similar option to buy, hence the term 'double or 'cross' option' agreement. In a double option agreement the seller can effectively force the other shareholders to buy, and the shareholders can force the deceased's executors to sell.

Some of the factors to be considered in drafting such an agreement are outlined below:

Time limit
There should be a time limit within which the option should be exercised. This will generally be between three and twelve months. Less than three months may be impractical while more than twelve months could mean long delays for the deceased's beneficiaries. It is usually recommended that the time limit for purchase is different from that for sale so as to avoid any implication that the agreement might be binding.

What price should be paid?
A fixed or specified price could give rise to an Inheritance Tax (IHT) liability or Capital Gains Tax (CGT) liability in the case of critical illness if the amount paid is less or more than the market value of the share. So, if a fixed price is chosen, it must be commercial and reflect the valuation of the business at the time of entering into the agreement. As the fixed price is unlikely to still represent a reasonable price after a number of years, regular reviews will be necessary. Reviews will be required with greater frequency if the share ownership is likely to change, or if the shareholdings are very disparate, or shareholders are of very different ages or in ill-health. The advantage of a fixed price (as long as it is reasonable) is that it can be 'matched' with life assurance policies.

An alternative would be for the price to be the market value of the shares at the time of the death of a shareholder. The agreement could provide for an independent valuation to be made by an appropriately qualified valuer, as this could avoid many of the problems and disputes that can arise in these situations. Some shareholders might, however, think that this method of valuation is less certain, and is thus less appealing.

Unless a fixed price applies, the amount paid out by the life assurance policy could exceed or be less than the amount required to purchase the deceased's shares. The agreement should provide for this eventuality and this is discussed later.

Covenants regarding payments

There should be a covenant in the agreement that payments on the life assurance policies will be paid and that if any policy becomes void or otherwise ceases, a further policy will be effected to replace it. Also, any options available under a policy should be exercisable only with the consent of the co-shareholders.

It is important that the agreement should not restrict the shareholders' rights to dispose of their shares as this could have adverse tax consequences.

Proportions of the deceased's shares to be bought by the continuing shareholders

The agreement should state the proportions in which the survivors will purchase the deceased's shares.

These are just some features which a double option agreement could contain. Quite clearly, different conditions and requirements exist for each individual case. The important thing is that professional advice should always be sought, which is why most such agreements are provided as draft only.

Agreement to cover share purchase following a shareholder's critical illness

The shareholders may decide to establish a combined, or totally separate, single option agreement to meet the needs of all parties should one of them suffer a critical illness. A single option agreement prevents the other shareholders from insisting that the shareholder who is critically ill sells their shares, though if the critically ill shareholder decided to sell the co-shareholders must buy. This gives that shareholder some measure of protection if they believe they will return to the business. A double option agreement is, however, also possible.

The agreement covering share sale and purchase following critical illness can be a 'stand-alone' agreement or could be merged with that covering sale/purchase on death.

STEP 2: Providing funds through life assurance

If life assurance cover is to be established, it is important to ensure:

- that the correct people have control over who receives the sum assured from the policy,
- that the sum assured is payable at the right time and,
- that the amount of cover is adequate.

Ensuring that the sum assured is appropriate should not be difficult.
In deciding how to structure the policies shareholders should be aware that there are two routes:

- the trust route and,
- the life of another route.

The trust route is recognised as the most flexible and a widely adopted solution.

However, the consequences of the life of another route is considered for example as follows:

- If there are three shareholders, A, B and C, A would take out policies on the lives of both B and C, B (on A and C) and C (on A and B) would similarly take out two policies each, giving a total of six policies.

The advantage of this is simplicity at the outset, because each of the shareholders would be an applicant and own one or more of the policies. It is they who will be entitled to the proceeds and will be making payments to policies from which they will ultimately benefit.
No trusts would be required.

However, the method is not without its problems:

- A shareholder may leave the company. On doing so, they may no longer have a use for the policies. The appropriate solution would be for them to assign their policies to whoever takes their place. This raises another problem. An assignment in these circumstances might well be for an 'actual consideration' which could mean that the proceeds of the policies would not be tax-free.
- If there are more than two shareholders the solution becomes complicated and potentially inflexible. With four shareholders, for example, there would be a need for twelve policies.

For these reasons the trust route is usually recommended.

On balance, it is felt that the only company for whom a life of another policy would be suitable will be a 'two shareholder business' where relative stability is envisaged with no departures and no new shareholders.

A more appropriate solution would usually be for each shareholder to take out a policy on their own life, written subject to a business trust for the benefit of the other shareholders. This can remove all the difficulties raised in respect of life of another arrangements.

The procedure in this case is for the life assured as the settlor to take out the policy and at the same time to declare a trust.

In the example of the company with three shareholders, A would take out a policy on their own life in trust for B and C. B and C would also take out a policy each, making a total of just three plans, each with their own trust.

Each settlor will be the initial trustee of their policy and will appoint additional trustees who will usually be all the shareholders. The trustees would be the legal owners of the policy and would hold it on trust for the beneficiaries, who would be the co-shareholders of the life assured in each case. Thus, on A's policy, the trustees would be A, B and C and the beneficiaries would be B and C in appropriate shares etc.

STEP 3: The Business Trust

The most appropriate form of trust is likely to be a flexible business trust. The trustees must be able to alter the beneficiaries whenever a change in the shareholders takes place, or this could happen automatically. Advice should always be taken before a trust is put in place. The power to change the beneficiaries (if positive action is required) should always lie with the trustees as a whole, rather than with one individual.

If a shareholder leaves the company and sells their shares there is no longer a need for the policy however, they may like to be able to use the policy for other purposes. This can usually be done, though the method will be governed by the trust. In such circumstances, the trust could provide for an automatic reversion of benefits to the departing shareholder or give the trustees power to appoint to the departee – or both. In a commercial arrangement, this power for the life assured to benefit under their own policy's trust would not cause an IHT problem under the reservation of benefit provisions.

It may also be necessary to consider the possibility of a Pre-Owned Asset Tax (POAT) charge. However, in most cases this is unlikely to give rise to any liability, see, Making the arrangement tax efficient (c) for more details.

Many life offices have standard trust forms and Zurich is no exception. The key thing to ensure is that the trust can be adapted to future changes. For example, if new shareholders join the company, can they be added to the beneficiaries under the trust?

The Zurich Flexible Business Trust is highly flexible and can allow for these changes, if required.

So, in summary…

Under the trust route on the death or critical illness of the life assured, the sum assured will become payable to the policy trustees. The trustees will pay the proceeds to the co-shareholders in accordance with the terms of the trust.

The next step is for the continuing shareholders to decide whether to exercise the option to buy the deceased's shares from the executors on death or from the critically ill shareholder as appropriate. It will also be for the executors or critically ill shareholder to decide whether to exercise their option to sell to the continuing shareholders or, in the case of a double option agreement, for both parties to agree that no sale or purchase is appropriate. Remember though, that under a double option agreement if one party decides to exercise their option, the other party must comply.

3 Issues to consider

What type of policy?

Type	Detail
Term assurance	This will provide the cheapest cover. A term assurance policy will enable surviving shareholders to buy the shares of a co-shareholder, assuming they are the beneficiaries of the policy, on their death before a certain date. Other arrangements will need to be made if the shareholder retains their shares after the expiry of the policy term. The policy may be renewable within certain limits.
Whole of life policy	A whole of life policy could provide the greatest flexibility as it will provide a sum payable on death, whenever that happens. If the shareholding director's retirement date is uncertain, or if they have no intention of retiring at all, or they wish to retain their shares after retirement, a whole of life policy may be the most suitable. Cost will, of course, be a key factor.

Type	Detail
Critical Illness	Critical illness policies will pay out the proceeds in the event of the life assured suffering from one of the critical illnesses covered by the policy. They can facilitate the sale of the shares during the shareholder's lifetime although an option agreement would need to accommodate this. Critical illness policies can provide critical illness benefit only, or they can be combined with term assurance or whole of life policies. Under these 'combined' policies, the benefits would be payable on the earlier of death or critical illness.

However, the use of these policies have their limitations in that they don't take account of the possibility of providing money to buy a shareholding director's shares on their retirement from a company, whether at a fixed or indeterminate date in the future.

Share valuation in relation to insurance cover

There can be difficulties in valuing a small company's shares and in fixing the level of life assurance and/or critical illness cover.

The valuing of shares in an unquoted company can be difficult and might require the assistance of an independent expert. Valuation isn't simply a matter of valuing the entire business and dividing that figure by the number of shares issued. Other factors need to be taken into account including:

- the nature of the business,
- the company's management,
- the company's asset value,
- the company's profitability,
- dividends paid,
- liquidity,
- the state of the economy,
- the demand for shares,
- the type of shares and rights attaching to them and,
- the size of any individual shareholding.

The size of a shareholding determines the extent of the control a shareholder can exert over the company. The control element governs to a significant degree the value of those shares. In general terms, the more shares a shareholder has, the more valuable their shareholding. Because of various company law rules, there are some key percentages at which the value of a shareholding changes dramatically.

Some key shareholdings and their implications are as follows:

Size of shareholding	Detail
75% or more	A holding of 75% or more of the voting shares carries the power to do most things concerning the company. The holder can pass a special resolution and can therefore liquidate the company, change the nature of the business, ratify acts beyond the company's powers, alter the composition of the board etc.
More than 50%, less than 75%	A holding of more than 50% and up to 75% gives owner effective control of the company without giving them power to pass a special resolution without the assistance of one or more of the other shareholders.
50%	A 50% holding does not carry control but it will prevent anyone else from controlling the company.
More than 25%, less than 50%	A holding of more than 25% but less than 50% is valuable in that it enables the holder to block a special resolution.
Less than 25%	A holding of less than 25% will only be useful where it can be combined with another holding to present a united front. Because a holding of this size cannot block a special resolution, its market value could well be significantly less than the aggregate of the value of each share in that holding.

The essential question for a valuer, for each of the factors discussed overleaf, is, to what extent must the apparent book value of the block of shares be increased or decreased by the presence or absence of one or more of these factors? For example, if a company is worth £1m, a 75% shareholding might be expected to be worth £750,000. A 10% holding, however, might be worth only £50,000. Even a 49% shareholding might be worth significantly less than £490,000 as it does not give control of the company. Frequently, when entering into a share purchase agreement, if all the shareholders are minority shareholders they will agree that the value of each shareholding will be a straight proportion of the value of the company without any discount for minority holdings.

Clearly the aim is to provide funds to purchase shares at some point in the future, and it is impossible to estimate how much will be required with any accuracy. One way forward is to establish the present value of each shareholding and ensure that the policy is sufficiently flexible to permit increases in the life cover in the future.

An alternative is for the agreement to set a 'specified value' as opposed to relying on an independent valuer. The big advantage of setting a 'specified value' is that the sum assured will be equal to it! However, any 'specified value' must reflect what is a fair market value in the first place (i.e. at the time of entering into the agreement), and it must be reviewed at least every three years, and more frequently if any of the shareholders are in less than good health, or the age difference between them is significant. If the specified value is not set on a sound commercial basis there may be adverse tax consequences, as described later. The 'commerciality' of the arrangement is essential.

Whatever option is chosen, regular reviews of the life assurance arrangements are essential as shareholdings and their value can change. The ability to increase the sum assured, without evidence of health, when share values increase could be of considerable benefit.

Unequal cost

Another aspect to take into account is the payments under each policy. Where co-shareholders are taking out policies for a similar purpose, policy payments will, of course, be affected by differences:

- in the life assured's age,
- in the life assured's state of health,
- in the sum assureds required as fixed by the value of the shareholdings.

Even if there is no concern over the payment disparity the shareholders should consider equalising the costs, so that the arrangement can be shown to be demonstrably commercial and therefore, CGT and IHT implications can be avoided.

Setting up the life assurance policy – the mechanics

The life assurance company will need all the necessary forms and will require full details of the life assured and the details of the people who are to become the legal owners of the policy.

The policy will require underwriting and there will be two considerations – financial and medical. Financial underwriting will establish whether the level of cover is correctly assessed and medical underwriting will establish the risk of death or critical illness of the particular life assured within the terms of the policy.

In order to avoid adverse tax consequences, it is very important – when using a trust – that the policy is not put into force before the trust is executed.

4 Taxation: Inheritance Tax, Capital Gains Tax and Pre-Owned Asset Tax

Making the arrangement tax efficient

The tax implications of share purchase and the necessary life assurance arrangements can be quite complex. However, tax should not be a significant problem. A solicitor is often involved in the establishment of a share purchase arrangement but a good start can be made by using a draft option agreement and a draft business trust usually provided by the insurer. Zurich provide both draft trusts and agreements.

a) Inheritance Tax (IHT) implications

IHT is relevant in three ways to share purchase arrangements:

- Subject to Business Property Relief (BPR), the shares may be subject to IHT as they form part of the estate of the deceased shareholder.
- Making payments to life assurance and critical illness policies, assuming they are large enough, may be chargeable transfers for IHT purposes.
- IHT may have to be considered in connection with the business trust to which the life/critical illness plans are subject.

While all three points are important, a properly constituted arrangement can ensure that Inheritance Tax should not be a problem.

IHT on the value of the shares

The shares could form a major part of the deceased's estate.

For IHT purposes HM Revenue & Customs (HMRC) would value the shares immediately before the shareholder's death and it is this value which is subject to tax. Business Property Relief is, however, likely to be relevant and this can remove or reduce any IHT otherwise payable on the shares.

BPR is a valuable relief which is available on transfers of business property during lifetime or on death. There are conditions that apply in terms of the type of business and the period the interest has been held. The business or an interest in the business must have been owned for two years and it must be a trading business.

The rates of relief are:

A business/interest in a business, including a share in a partnership	100%
Shares in unquoted companies, including AIM shares	100%
Controlling shareholdings in quoted companies	50%
Land, buildings, plant or machinery owned by a controlling shareholder and used wholly or mainly in the business carried on by the company	50%

In all cases the relief is only available to the extent that the value of the shares is represented by relevant business property – i.e. not investments. Generally, only trading businesses qualify for the relief.

Where the shares are not being left to the shareholder's spouse, or civil partner, it is important to be able to benefit from this relief. However, the relief can be lost if there is a binding contract for the sale of the shares at the date of death. However, HMRC have indicated that a double option agreement is not regarded as a binding contract for sale for these purposes and the relief is still available. It is for this reason that share purchase agreements are set up using options to buy and sell, although some agreements may exist which constitute binding contracts for sale. In these cases, it will usually be better to substitute a new double option agreement for the old one.

IHT should not be relevant in connection with a purchase on commercial terms following a shareholder's critical illness.

Making payments to life assurance policies

If the policies are set up on a life of another basis, payments will not have IHT implications. If, however, the policies are held in trust (as they will be in most cases), the payments will be on the face of it transfers for IHT purposes.

In most cases though, payments paid under a life assurance policy held subject to a business trust will not constitute transfers of value as the payment will be made as part of an 'arm's length' commercial arrangement.

It is in fact essential that the arrangement is 'commercial'. This is because, even if the settlor were not a beneficiary under the trust of the policy he effected on his own life, he will be a beneficiary under the policies effected by his co-partners and they will be beneficiaries under his own policy. This means that each party could indirectly benefit and therefore, if the premiums were treated as gifts, there could be a reservation of benefit by associated operations for IHT. Under the Zurich Business trust the beneficiaries are confined to persons involved in the business and therefore, subject to any premium equalisation (see earlier) , the arrangements will usually be treated as commercial. If there is no gift there cannot be a gift with reservation of benefit.

IHT on the Business Trust

Payment of the policy proceeds should not give rise to any IHT problems. If the policy is on a life of another basis, the proceeds will be paid to the policy holder (i.e. the surviving shareholder) and, because the surviving shareholder already owns the policy, there is no question of any IHT being payable.

If the policy is held in trust, the proceeds will be paid to the trustees. They will not form part of the deceased's estate (because they are trust assets and the arrangement was commercial) and accordingly will not have any impact on the deceased's IHT liability.

As the trust would not be a bare trust, it would be necessary to consider periodic and exit charges under the 'relevant property regime'. These could apply even if the arrangement is commercial. These are relatively complex provisions but in most cases no charge should arise – regardless of the size of the sum assured.

There may be a risk of a charge (periodic and subsequent exit) if the policy has a substantial value, the payments paid are substantial or the life assured is in serious ill health. Professional advice is essential. For plans with large sums assured it may be worth considering providing the required sum assured through a series of plans each effected on separate days and each subject to a separate (identical) trust. This would, under current law, ensure that each trust would (in most cases) have its own nil-rate band and thus would minimise the risk of any IHT charge. Again, professional advice is essential if this type of planning is to be carried out.

b) Capital Gains Tax

This tax could be relevant in respect of the sale of the shareholding and, in particular, on sale following critical illness. For CGT purposes the shareholding is revalued at the date of death so that any CGT liability to date is effectively wiped out on death. However, if the sale of the shares were to take place at a significantly higher value than the value at the date of death (which could happen, for example, if there were a lengthy delay between death and the date of exercising the option to buy or sell), there could potentially be a liability to CGT.

For a sale following critical illness, there will be no revaluation and so the capital gain realised on sale could be significant albeit charged at a rate of 20% (10% for gains falling within the basic rate band) on gains in excess of the annual exemption. Entrepreneurs' Relief may be helpful as it can reduce the effective tax rate to 10% on gains made up to a (lifetime) cumulative total of £10 million since 6 April 2008. CGT can of course reduce the net proceeds of a sale, in particular following critical illness. Its potential impact should thus be taken into account when determining the sum assured provided under life assurance plans in a business succession arrangement.

c) Pre-Owned Asset Tax

If a business owner can benefit under a trust of a policy effected by them, even if it is part of a commercial arrangement between business owners for enabling share purchase, HMRC could apply the POAT provision, potentially resulting in an income tax charge each year.

If they do, broadly speaking, the charge is found by applying and interest rate, currently 2.5%, to the value of the settled property. However, no tax will be payable unless the POAT charge exceeds £5,000 for each settlor, which would be unlikely in most cases.

5 Keeping everything under review

Dealing with change

Share purchase arrangements are long-term solutions but which need regular review. Throughout the course of these arrangements, circumstances will change but, properly drafted, they should be able to cope with changes such as the shareholding of a particular shareholder increasing (or decreasing). There needs to be some flexibility.

Changing requirements may mean changes to the option agreement; to the life and critical illness policies (both the amount of cover and type of policy); and to the trust arrangements.

It's important that all the components of share purchase arrangements are regularly reviewed.

The option agreement(s)

The agreement will need to be reviewed regularly to ensure that it reflects the continuing requirements of the shareholders. For example, on the business side it may be decided that a new method of valuation is necessary. If changes are required (such as a change in the 'specified value'), these may be effected by a supplemental agreement, or memorandum, or the original agreement could be brought to an end and a new one entered into.

The life policies

The sum assured under each policy should be reviewed from time to time for a variety of reasons:

- the value of an individual's shareholding could increase, as a result of the company's success,
- the shareholder may acquire more shares, perhaps because another shareholder has sold their shares to them.

In any event the policies will need to be reviewed on the death of a shareholder. Often, the agreement will provide for it to finish once the sale and purchase is complete.

If the agreement is to continue, or a new agreement entered into, the policies may need to be increased as each of the surviving co-shareholders will have an increased shareholding.

There are two ways of increasing the cover:

- the shareholder could take out a further policy, or
- they could exercise an option under the existing one.

The latter course of action, if it is available, could be cheaper and, in some cases, can be done without further medical underwriting which itself could be a very valuable aspect of the policy. When taking out a policy, it is clearly worth considering how it might be adapted in the future to meet changing needs, not only in terms of increasing the sum assured, but also (if the policy is convertible) of exercising the option to convert, for example, to a whole life policy.

The trust arrangements

With co-shareholders coming and going, it is necessary to ensure that the trust continues to reflect requirements. The more flexible the trusts are, the easier it is to change the beneficiaries and trustees if this becomes necessary.

Left-over policies

For a variety of reasons, it is possible that one or more protection policies may become 'surplus to requirements'. This would happen if:

- a shareholder sells their shares,
- the company is wound up,
- the double option agreement is terminated,
- all the shareholders except one could die, thereby enabling the survivor to buy all the shares under the double option agreement.

In all these situations it must be decided what will be done with the remaining policy on the life of the shareholder in question. The decision will depend on whether the policy was effected on an own life in trust or life of another basis.

Life of another

Where, unusually, there is a life of another arrangement and shareholder A sells their shares, the best solution would be for the other shareholder(s) to assign the policy(ies) on A's life to shareholder A, and for shareholder A to assign their interest in the policy(ies) on the co-shareholder's(s') lives to those continuing in the business.

Where one of the shareholders has died, their interest in the other policies, which were taken out on the lives of the other shareholders, will also form part of the deceased's estate. They will pass to the chosen beneficiaries under the deceased's Will and it is important to bear this in mind. If the policy is a term assurance, the beneficiary might be prepared to assign the policy to the life assured although there might be reluctance to do this if the policy has a surrender value.

It is the inflexibility and difficulty attributed to life of another policies that make the 'own life in trust' solution far more appealing in most cases.

Own life, in trust

Where the policies are written under a flexible business trust, the position is simple. When the cover on the life of a shareholder is no longer required for its original purpose, the trustees should appoint (i.e. redirect) the benefits of the policy, in accordance with any power of appointment, by means of a simple deed to the life assured so that the policy can be used for other purposes. In many cases, the trust will automatically provide for a reversion of benefits to the life assured when a shareholder leaves the business and disposes of shares.

Of course, if the life assured becomes entitled to the benefits, the value of the policy will form part of their estate. It will, however, be open to that person to make their policy subject to a new trust for the benefit of family/dependants.

Surpluses and deficits

Setting a 'specified value' overcomes the potential problems of surplus and deficit. If such a solution is not adopted, though, then given the difficulties in valuing shares it is possible that sum assured from the policy could exceed or fall short of the amount required to purchase their shares. There should be a provision in the option agreement dealing with this point.

- The agreement should specify that in the event of a deficit, the balance of the purchase money will be paid within a certain period of time. The fact that there might be a deficit will not prejudice the deceased's executors' ability to exercise the option to sell; neither will it affect the obligation of the surviving shareholders to buy. It will be up to the survivors to raise the necessary amounts, but it could help if the agreement permitted payment by instalments. The agreement could provide for interest on outstanding amounts at an agreed rate
- Where there is a surplus of policy proceeds, the continuing shareholders would normally retain the proceeds for their own use, or to inject into the company loan account. There should not be a provision for payment of any surplus to any third party.

What is important is that all these possibilities should be considered when the agreement is entered into and professional advice sought.

Other useful references:

- Guide To Company Share Purchase
- Guide To Key Person Protection
- Business Protection Premium Equalisation

Contents

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